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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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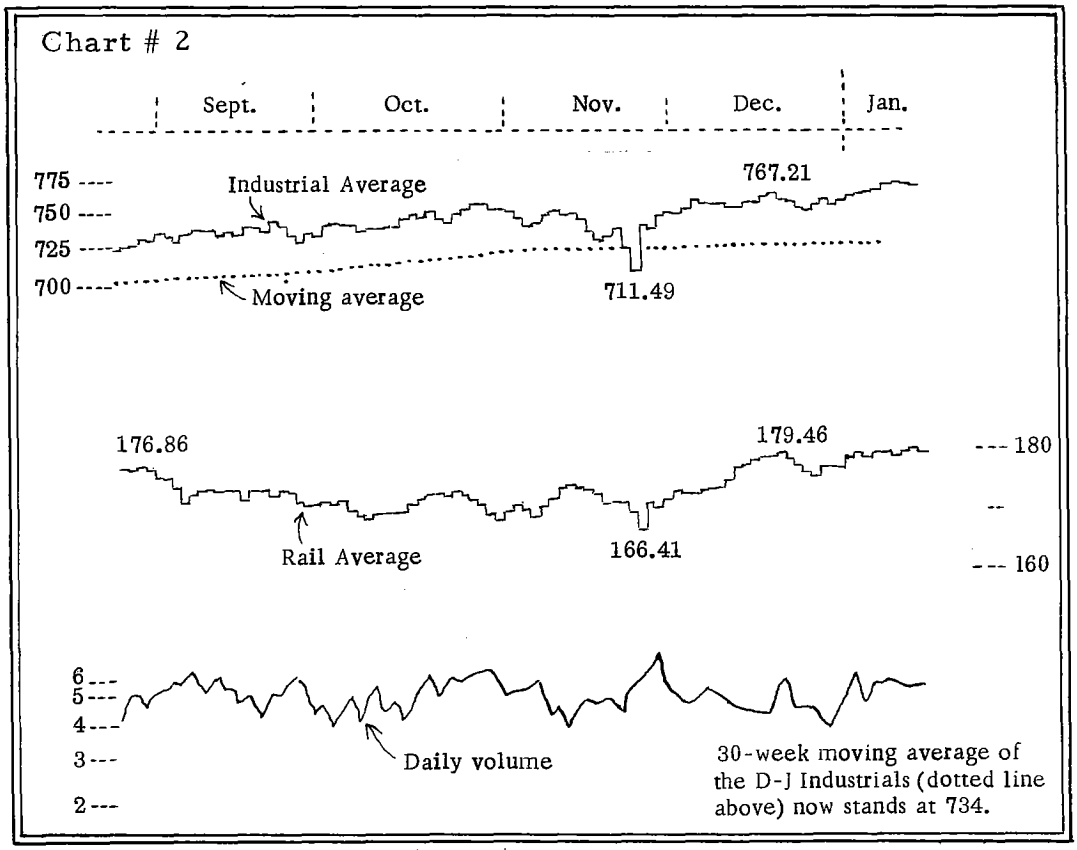
In the last Letter I discussed three courses which the market might take in 1964. So far, the market appears to have elected the third and most dangerous course — namely, a further extension of the 1962-63 advance in the face of a major and continuing divergence between the Industrial Average and the advance-decline ratio.

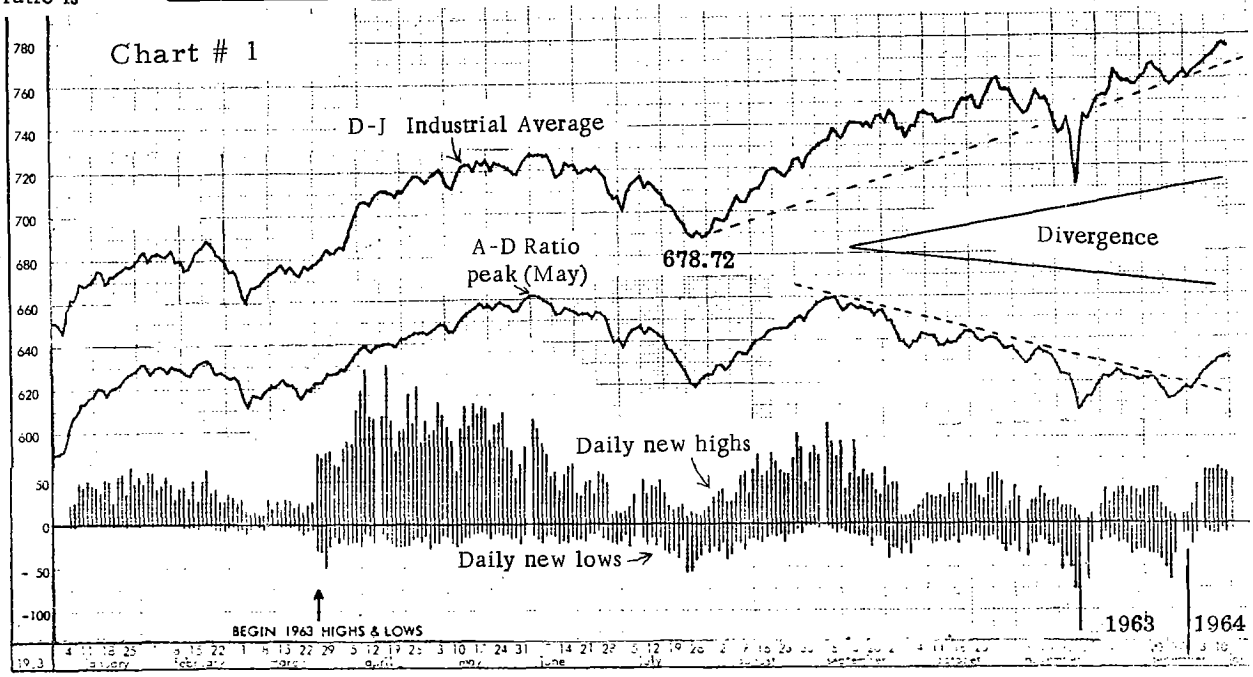
Why do I label a further rise as "the most dangerous course"? Because the greater the Industrial advance, the greater the technical "vacuum" created by the Industrial Average on the one hand and the mass of stocks (as measured by the A-D ratio) on the other hand.

This vaccum will be filled (in my opinion) in 1964 just as it was filled in 1960 and again in 1962. But in 1960 the vacuum was filled with the Industrial Average at 685.47 and with the A-D ratio at approximately its 1956 high. A 119 point Industrial decline followed. In 1962 the vacuum was filled with the Industrial Average at 734.91 (December, 1961, saw the actual Industrial peak) although the A-D ratio was considerably below its 1959 peak. A 199 point Industrial decline followed.

1962: The Industrial Average is currently about 45 points above its 1961 peak, but the A-D ratio is now far below its 1961 high. This fact taken together with the huge "broadening pattern" which is now apparent in the Industrial structure (see Chart #3 this Letter; also see Letter #240) should provide the technical formula for "fireworks" (and I repeat my statement of last week: 1964 will be a year to remember).

SHORT-TERM: On December 31 the





A-D ratio (lead by the persistent rise in the two D-J Averages) reversed its declining trendline, a trendline which had been in force since September 5, 1963. This resulted in a turn to strength in the majority of stocks, and the upward progress of the A-D ratio can be seen on Chart #1. Throughout January, 1964, the Industrial and Rail Averages have "see-sawed" into new high ground, first one Average rising, then the other, in an erratic advance which saw daily new highs rise to a peak of 65 on January 7 (a surprisingly low figure when we consider that the senior Average is at a record high).

Can the Averages continue to rally while the majority of stocks, as measured by the A-D ratio, remain below their 1963 peak? This could happen, although it has only occurred twice before -- in 1959 and 1929. Both of those years, by the way, were very difficult for traders and investors.

What are the odds that the A-D ratio will now better its May, 1963 high? There can always be a market "first", but up to now the Industrial Average has never succeeded in pulling the A-D ratio up to a new high. Personally, I prefer not to bet against all previous market history. Therefore, until proved otherwise, I would guess that the A-D ratio (and the majority of issues on the N.Y.S.E.) have definitely "topped out" of this rise. And as long as the May, 1963, A-D ratio peak stands, the market is (technically) in dangerous territory.

Despite past history, what would it mean if the A-D ratio were now to surpass its 1963 peak? If this did occur, it would suggest to me that the market was on its way to an "explosion" on the upside. In that case, I would probably recommend purchase of depressed low-priced issues on the N.Y.S.E. But until the A-D ratio does better its 1963 high, I continue to believe that this market is not going to be a profitable place for me or my subscribers. I have studied the action of stocks during many periods of major breadth-price divergence, and my conclusion is that the average investor does not regret having stayed out of the market during those periods.

NOTE: Because many subscribers have requested it, I have included (Chart # 1) the record of the (daily) advance-decline ratio and the Industrial Average together with daily new highs and lows for the entire year 1963 to date. This is a valuable record, and since I will undoubtedly refer to it many times again, I hope subscribers will save this chart.

A LONG VIEW Chart # 3 traces the major movements of the D-J Industrial Average from the period of 1942 to date. The chart is drawn to semi-logarithmic scale, which means that all movements are correctly shown in terms of percentages. Thus, a rise from 100 to 200 on the chart (a rise of 100%) will occupy the same vertical distance as will a rise from 300 to 600 (also a 100% rise).

The first massive upward market movement began in April, 1942, while the Allies were engaged in a death-struggle with the Axis forces. When the Average turned up in early 1942, the outcome of the war was still very much in doubt. However, the market in its "unconscious" wisdom, foresaw the final outcome long before it was apparent to any individual.

The period from 1942 to 1946 was accompanied by the most astounding rise in "breadth" (i.e., the advance-decline ratio) on record. From the depressed levels of 1942, it seemed that every stock on the Board simply kept rising — week after week and month after month. The great advance ended in mid-1946, following which the Industrial Average broke badly.

It is of great interest to note that the halfway level of the entire 1942-46 swing for Industrials was 152.71. Veteran readers of these Letters know how much importance the writer attaches to the action which occurs at the halfway level of major swings (I have previously referred to this as the 50% principle). Following the 1946 top, the Industrials tried four times (September, 1946; May, 1947; March, 1948; June, 1949) to penetrate the 152.71 level or the halfway point of the 1942-46 rise. The nearest the Industrials came was the famous 161.60 close of June 13, 1949. The remarkable ability of the Industrial Average to retain better than half its preceding gains following a major bull market rise, held bullish implications for the future. Following the final 1949 low, the bullish promises were carried out.

From 1949 to 1956 the Industrial Average rose in a massive swing which took that Average from 161.60 to 521.05. During the same period the Rail Average increased over 400% and the A-D ratio climbed steadily higher.

Between 1956 and 1957 the market ran into trouble. The advance-decline ratio turned down in March, 1956 while the Rail Average reversed to the downside in May, 1956. During 1957, the downside momentum increased. Between July and October, 1957, the Industrial Average lost 20% of its value while the Rail Average cut itself almost in half. The A-D ratio also dropped sharply during most of 1957. Of great interest, however, was the fact that the

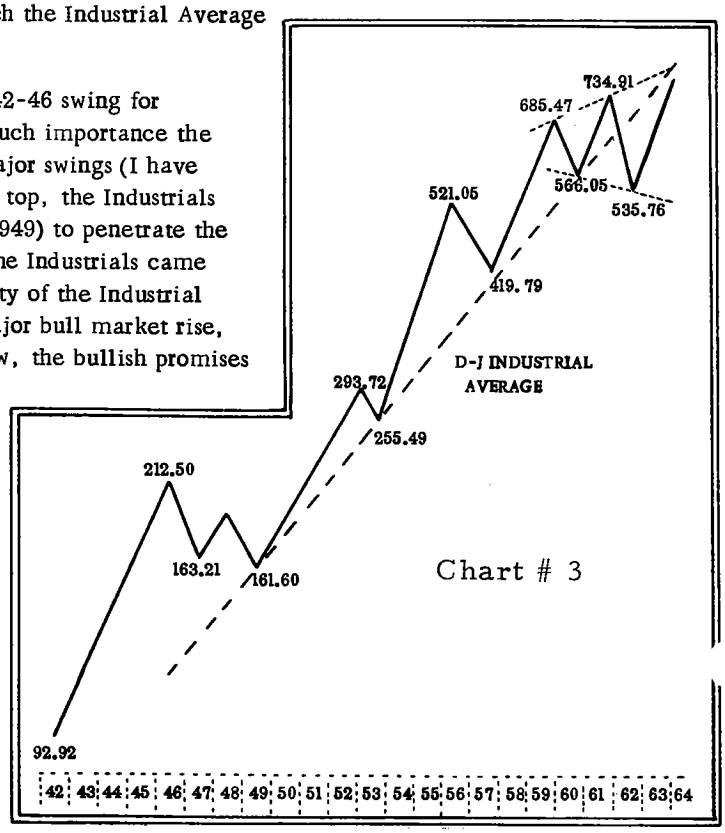


Chart # 3

1957 Industrial low (419.79) was well above the 50% level of the 1953-57 rise (the 50% level was 388.27).

An explosive new rise took the senior Average to 685.47 in January, 1960. The interesting thing here, however, was that the A-D ratio failed by a small fraction to surpass its 1956 peak. The market turned down in a long movement which saw Industrials strike bottom in October, 1960 (566.05). Here again Industrials held above the halfway level of the preceding (1957-60) major advance. The halfway level of the 1957-60 rise was 552.63.

From the 1960 low the market pushed up again, and this time Industrials succeeded in extending their rise to a late-1961 peak of 734.91. The A-D ratio had already turned down in May, 1961, following a short seven-month rise. But it was in 1962 that something really new occurred. In the spring of 1962 Industrials collapsed with such violence that they actually broke below their preceding 1960 base of 566.05. In so doing, they violated the halfway level of the 1957-60 rise (552.63), and they also violated the halfway level of the entire 1957-61 rise (557.35). Furthermore, for the first time, the great rising Industrial trendline of the 1950's (see chart) was penetrated. As a final consideration, the A-D ratio during the 1962 decline broke below its 1960 and 1957 levels, dropping to its lowest point since January, 1954. The market seemed to have suffered its most important technical damage of the past two decades.

Nevertheless, from the 535.76 low of June, 1962, the Industrials rose again, in a movement which was to take the senior Average (on September 5, 1963) above its 1961 high. Market students noticed, however, that the A-D ratio had turned down in May, 1963, in the face of the continuing strength in the Industrial Average.

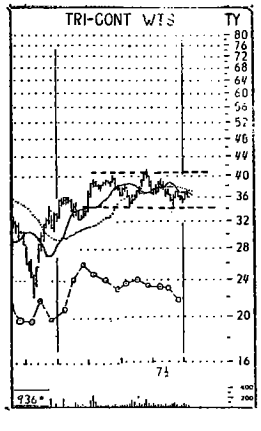
The problems connected with the (current) 1962-64 rise are in many ways the most fascinating and complex this writer has ever seen. (1) The Industrial Average (see Letter 240) has now formed a huge "broadening pattern" with each peak since 1959 above the preceding peak and each low since 1960 below the preceding low. Such a "five-point reversal pattern" is generally considered to be bearish (it is a picture of wild, gyrating action). (2) The A-D ratio "topped out" in the first half of 1963. When this has occurred in the face of a persistent Industrial advance to new highs in the second half of the year, it has spelled trouble for the market. This was detailed in the last Letter. (3) The current rise is taking place following a collapse (1962) which violated the 50% level of the preceding major advance. The writer feels that the 1962 violation of the entire 1957-61 rise should be accepted as a definite warning. (4) The current rise is taking place following a violation of the great Industrial trendline as shown in Chart # 3. Perhaps coincidentally, the top of the potential broadening pattern and the underside of the huge trendline meet at about 795 on the Dow.

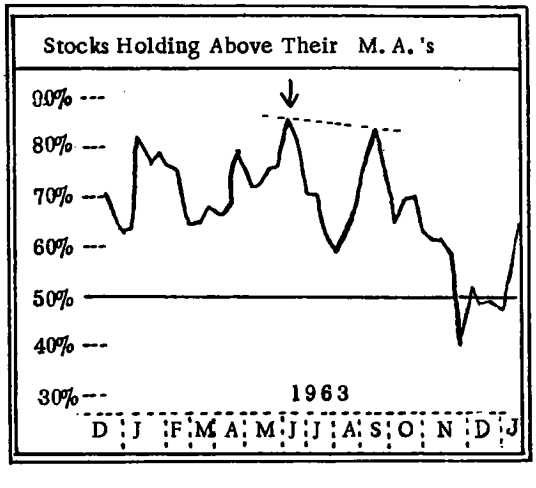
On the positive side we have an unprecedented year-and-a-half of odd-lot selling to bolster this market. Furthermore, we have had the lowest odd-lot participation (as a percentage of total N.Y.S.E. trading) on record during the past year. This would suggest that the market has been rising without benefit of the public. And as another strong bull argument, the current market contains the largest short interest on record (over 7 million shares sold short). This means that there are a great many bears who will be forced to cover if this market fails to show weakness during the period ahead.

CONCLUSION: I believe that today's market can be likened to a long-distance runner who is suffering from a fatal malignancy. The runner may be getting ready to put on a final sprint and finish the race, but the effects of the disease are becoming apparent. The grandstand crowd may be willing to bet on the long-distance runner, but the doctors who have examined him will keep their money in their wallets. They know that there will be other races and better odds, and they prefer not to bet on a sick man — regardless of what surprising strength he may finally be able to muster.

STOCKS Of 432 stocks tabulated weekly at this office, 278 or 64% are now holding above their 200-day moving average (see chart below). Last week the bullish percentage rose to 56% and this week we are up another 8%. This study is now bullish. If the majority of stocks can make upward progress from here, we should see that progress confirmed by a rising A-D ratio as well.

Some time ago I wrote a piece on the use of Tri-Continental Warrants as a speculative barometer. These usually sensitive Warrants constitute a perpetual "call" on the nation's largest closed-end fund, Tri-Continental Corporation. The weekly chart (below) shows that the Warrants have been in a "rectangle" pattern for many months. A rectangle is much like a "line" in the Averages -- it is a pattern of "indecision". A decisive break above the upper rectangle limit (41) or a break below the lower limit (34) would suggest a considerable further move for the Warrants in the direction of the breakout. In the meantime, the Warrants seem to be reflecting the "stalled-out" breadth of the market.





A good many analysts are recommending the Steel group at present. I wrote up Jones and Laughlin in Letter 235, calling it the strongest of the steels (it has since risen 10%).

The Steel Group is probably in the process of reversing a four-year decline in popularity. As seen on the relative strength (R. S.) chart at the bottom of the page, Steels have been acting slightly better than the market since mid-1963. Before saying that Steels have definitely turned up in R. S., however, I would like to see the group better trendline "A" on chart. The most interesting speculation in this group — Detroit Steel (chart below).

While the Steels are depressed but looking better, the Motors are near an all-time high in R. S. but looking poorer. The bellwether of the Motor Group, G. M. , has cracked its long, ascending R. S. line, and the stock now seems to meet heavy selling every time it touches 80 (chart below). This suggests that GM's October, 1963, high will stand for quite some time. Chrysler (chart below) is also running into trouble. Its December rally failed to better the high-volume October peak, and the stock has sunk back to the 80 area for the second time. Chrysler's R. S. has declined to a four-month low, and I believe the stock is forming a (bearish) descending triangle. A break below 80 (40 on the new stock) would complete the distribution formation. Conclusion: stay away from the motor group — the odds are that they have already discounted any and all of 1964's "good news".

Many people are skeptical about Government cut-backs in defence — but the Aircraft and Electronic stocks act as if they believe it. Aircraft are already depressed, but such stocks as Beckman, Litton, AMP, Varian, Avco, Standard Kollsman, are now the poorest acting issues on the Board.

Strongest groups at present are Airlines, Drugs and Textiles. Most interesting stock among the three groups is Schering (Drug) which has formed a huge ascending triangle with a "break-out" level of about 48 (see chart). Schering was selling for over 80 in 1960, following which it collapsed to a low in 1962. Scherings R. S. line reversed to the upside a few months ago, after a three-year decline.

FOLLOW-UPS Sperry Rand (Letter 232) trying hard, but now getting hit by general weakness in the Electronic Group. Paramount Pictures (see Letter 235) still best acting in the neutral Motion Picture Group. Two depressed stocks (Letter 239), Lowenstein and Bucyrus (see chart) act well. Bucyrus (in a poor Machinery Group) acts so well I wonder if there is news coming out on this issue.

Charts of TY Warrants, DES, SRG and BY courtesy of Quote Digest, 110 North Lorraine, Wichita, Kansas.

Chart # 1 and charts of C, GM and Steel Group courtesy of Traders Research, 1431 Pearl Avenue, Alton, Illinois 62003.